Implications of the Separations Legacy for
Implementation of the Telecommunications Act of 1996

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I. Synopsis

The Federal Communications Commission's ("Commission" or "FCC") stated objective in initiating the CC Docket No. 96-262 access charge reform proceeding is to "end up with access charge rate structures that a competitive market for access services would produce."[1] Specifically, the Commission's goal is to foster competition in the telecommunications services market by ensuring that access charges "more closely reflect economic costs."[2] To that end, the Commission seeks comments on two possible approaches for determining interstate access charges on a going-forward basis. Under either approach, local exchange carriers' (LECs') revenues for interstate access services are likely -- if not certain -- to be considerably lower than their current revenues for such services. The reason is simple: by deliberate regulatory design, current interstate access rates are set at levels necessary to recover not only the actual economic cost of providing access, but also a significant portion of the LECs' other costs, particularly non-traffic-sensitive network costs and other common costs.

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[1] *Access Charge Reform*, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, CC Docket No. 96-262, FCC 96-488 (rel. Dec. 24, 1996) ("*Access Reform NPRM*" or "*Notice*"), at ¶ 13.

[2] *Id.* at ¶ 14.

Through a long series of decisions spanning six decades, federal and state regulators decided to allocate a large share of these costs to the interstate jurisdiction, in order to further explicit public policy objectives, notably the promotion of universal service and the maintenance of low local telephone service rates. These policy decisions have determined the jurisdictional allocation of billions and billions of dollars of LEC costs.[3/] These policy decisions are given legal effect in the Commission's Part 36 rules governing the separation of the LECs' regulated expenses and investment between the state and federal jurisdictions.[4/] Pursuant to the Commission's current Part 69 access charge rules, the costs allocated to the interstate jurisdiction are recovered through interstate access charges.[5/] All segments of the telecommunications industry agree that the costs allocated to the interstate jurisdiction, and recovered through access rates, exceed the LECs' incremental cost of providing interstate access services. As noted in the *Access Reform NPRM*, the Commission, in adopting the Part 69 rules, "did not seek to eliminate implicit support flows, but in fact incorporated such flows into the Part 69 rate structure."[6/]

If implemented, the access reforms proposed by the Commission will drive interstate access rates toward the incremental cost of providing these services. In other words, either of the alternative approaches to access charge reform discussed in the *Notice* would drive the

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3/ As demonstrated in Attachment 13 to the U.S. Telephone Association's Comments in this proceeding, the amounts driven by policy decisions to the interstate jurisdiction are very substantial. As illustrated in the attachment, on various occasions, the Commission or Joint Board actively considered alternative bases for allocating certain costs that could have increased or decreased by billions of dollars the amount allocated to each jurisdiction.

4/ *47 C.F.R. § 36.*

5/ *47 C.F.R. § 69.*

6/ *Access Reform NPRM* at ¶ 6.

"implicit support flows" out of the interstate access rate structure. But the reforms will not alter the jurisdictional allocation of LECs' non-traffic sensitive costs and other common costs. Reform of the jurisdictional separations process has been deferred to a future proceeding.[7] Until and unless the separations rules are changed, the Commission must provide the LECs a way to recover the prudently incurred costs that they are required, by the separations rules, to allocate to the interstate level. In enacting the Telecommunications Act of 1996, Congress sought to promote competition, not to deny the LECs the legal right to recover prudently incurred costs. There is nothing inherently wrong with a policy-based division of LEC costs between the jurisdictions -- indeed, it is probably inevitable in a regulated environment. But regulators' obligation to provide for the recovery of these costs flows from their policy determinations. Constitutional precedents clearly protect the LECs from rules that would result in confiscatory rates.

To its credit, the Commission acknowledges and addresses this issue at some length in the *Access Reform NPRM*, and recognizes the legal and practical necessity of permitting the LECs to recover their prudent and reasonable actual costs of operation. Under either access reform option, the Commission has a legal and equitable obligation to provide a reasonable opportunity for the recovery of these costs.

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[7] *Id.* at ¶ 6.

II. Introduction

For more than 60 years, there has been a fundamental debate between federal and state regulators regarding the relative proportion of local exchange carriers' non-traffic-sensitive network (*e.g.*, local loop costs) that should be recovered from interstate and intrastate services, respectively. The jurisdictional separations process, whereby LECs' network and related costs are allocated between the federal and state jurisdictions, has been the principal area where this debate has manifested itself. However, throughout the 60 years of debate, both federal and state regulators always recognized that LECs should be permitted an opportunity to recover their prudently-incurred embedded costs, in the aggregate, through the rates they charge for interstate or intrastate services. The costs allocated to the interstate jurisdiction determine the LECs' interstate revenue requirement, which they currently recover from the interstate access charges they collect from interexchange carriers. Likewise, the costs allocated to the intrastate jurisdiction are recovered from local telephone service rates, intrastate toll rates, and intrastate access rates.

The fundamental debate has revolved around the question of how to allocate primarily non-traffic-sensitive costs such as local loop plant.[8] Federal regulators have contended that the embedded costs of the local loop should be borne principally by the intrastate jurisdiction since they are related to the local loop which is required to provide local exchange service. State regulators, on the other hand, have argued that a larger share of local loop costs should

[8] To illustrate the manner in which costs have been and are currently separated between the jurisdictions, this affidavit focuses primarily on non-traffic-sensitive costs. The same fundamental issue applies to all other common or joint costs assigned to the interstate jurisdiction.

be allocated to the interstate jurisdiction since the local loop is necessary to provide interstate interexchange service as well as intrastate interexchange service and local exchange service.

Over the years, the jurisdictional separations rules have been modified periodically, but one core feature has remained constant over six decades: these rules have been consistently designed to promote the public policy goal of encouraging universal service by keeping local exchange rates low while, at the same time, ensuring that LECs earn a reasonable return on their investment in the telephone network.

Although historically there has been a hot debate between federal and state regulators regarding the appropriate allocation of non-traffic-sensitive costs, there always remained a general agreement among these regulators that such costs are real and legitimate expenses which should be recovered, in the aggregate, from LEC customers in the interstate or intrastate jurisdictions. Under the current rules, 25 percent of certain regulated LEC costs, including primarily non-traffic-sensitive costs, are allocated to the federal jurisdiction,[9] even though interstate traffic actually represents only about 15 percent of local loop usage.[10] The importance of the recovery of these common non-traffic-sensitive costs is clear from the fact that over 95 percent of a LECs' total costs for regulated services are common or joint costs.[11]

While the Part 61 LEC price cap rules, adopted in 1991, severed the direct link between the costs allocated to the interstate jurisdiction and the LECs' interstate access

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9/ *Amendment of Part 67*, Decision and Order, 96 FCC 2d 781 (1984)

10/ *See* FCC Monitoring Report, CC Docket No. 80-286, Table 4.7 (rel. May 1996).

11/ FCC Access Reform Task Force, *Federal Perspectives on Access Charge Reform: A Staff Analysis* (April 30, 1993) at p. 65 ("*FCC Task Force*").

prices, the price caps were initialized on the basis of the LECs' jurisdictionally separated interstate costs, and therefore continue to reflect the support flows incorporated into the separations process.[12]

The legacy of the allocation of a significant portion of common loop costs to the interstate jurisdiction takes on heightened importance following the enactment of the Telecommunications Act of 1996 (the "1996 Act").[13] The new law has triggered a process that will result in significant changes to the policies and rules governing the pricing of LECs interstate services. The FCC has begun a comprehensive series of interrelated proceedings to implement the statute, including the instant proceeding on access charge reform, the Docket No. 96-45 Federal-State Joint Board on Universal Service,[14] and the CC Docket No. 96-98 interconnection proceeding.[15] Thus, in the next year, the FCC is likely to complete a major overhaul of both the access charges regime and its policies for promoting universal service.

As interpreted by the Commission, a major thrust of the 1996 Act is to promote the pricing of telecommunications services on the basis of the "incremental cost" incurred in providing them. A further objective is to eliminate "implicit" universal service subsidies and

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[12] *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990) and Erratum, 5 FCC Rcd 7664 (1990).

[13] Telecommunications Act of 1996, Pub. L. No. 104-104, 100 Stat. 56, approved Feb. 8, 1996.

[14] Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Notice of Proposed Rulemaking and Order Establishing Joint Board, FCC 96-93 (rel. Mar. 8, 1996).

[15] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Notice of Proposed Rulemaking, FCC 96-182 (rel. Apr. 19, 1996), 61 Fed. Reg. 18311; First Report and Order, FCC 96-325 (rel. Aug. 8, 1996) (*"Interconnection Order"*).

replace them, where needed to ensure universal service, with explicit subsidies. In the local competition proceeding, the FCC advocated basing LEC interconnection rates on forward-looking long-run incremental costs.[16]

Likewise, the Commission's ultimate objective in this proceeding is to drive interstate access rates down to their forward-looking incremental costs. To that end, the Commission proposes two alternative approaches to access reform. The first alternative is a "market-based approach" that would "rely on potential and actual competition from new facilities-based providers and entrants purchasing unbundled [network] elements to drive prices for interstate access services toward economic costs."[17] The second alternative discussed in the *Notice* is a "more prescriptive approach" under which the Commission would "require incumbent LECs to move prices for interstate access in their service areas to more economically-efficient (*sic*) levels pursuant to rules adopted in [the access reform] proceeding."[18]

Either of these approaches, or a combination of the two, would inevitably result in a significant reduction in interstate access rates. The Commission recognizes this fact in the *Notice*, and to its credit, devotes considerable attention to the implications flowing from such

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[16] *Id.*

[17] *Access Reform NPRM.* at ¶ 14. The Commission proposes to implement this market-based approach in two phases. In the first phase, upon a showing that rivals are able to enter its local market through interconnection, unbundled network elements, and resale, an incumbent LEC would be allowed to deaverage geographically its interstate access rates; offer volume and term discounts and contract-based tariffs for interstate access; and introduce new access services on a deregulated basis. In the second phase, an incumbent LEC's access services would be deregulated -- i.e., removed from price cap and tariff regulation -- when the LEC faces "substantial competition." *Id.* at ¶ 15.

[18] *Id.* at ¶ 16.

a change. Specifically, the Commission acknowledges and addresses "the issues relating to the potential difference between the revenues that incumbent LECs generate from current interstate access charges and the revenues that revised access charges are likely to generate."[19] Moreover, the Commission notes that

> Some of the difference between the incumbent LECs' interstate-allocated embedded costs and forward-looking costs may be traced to past regulatory practices. For example, interstate access rates may exceed forward-looking economic cost, and thus produce some difference, because of misallocation of costs to the interstate jurisdiction.[20]

The Commission also discusses the need for "alternative methods of recovery of that difference."[21]

It is important to stress that interstate access revenues will fall short of the level necessary to recover the embedded costs that are allocated to the interstate jurisdiction under all of the access reform options discussed in the *Access Reform NPRM*. The *Notice* appears to focus in particular on the revenue shortfall under the second reform option, the "prescriptive approach," acknowledging explicitly that "the Commission would be required to determine how much of the difference incumbent LECs should be given a reasonable opportunity to recover and the method for that recovery."[22] However, a revenue shortfall is also inevitable under the "market-based approach" or any combination of the two approaches. The basic premise of the market-based approach is that competition from other facilities-based carriers, and from carriers purchasing unbundled network elements from

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[19] *Access Reform NPRM* at ¶ 241.

[20] *Id.* at ¶ 249.

[21] *Id.* at ¶ 241.

[22] *Id.* at ¶ 143.

incumbent LECs at rates based on forward-looking long-run incremental costs, will force incumbent LECs to lower their access rates. This is undoubtedly correct. If competitors are able to offer access services by reselling network elements purchased from the incumbent LEC at incremental cost, the LEC will have no choice but to lower its own access rates to the same level in order to remain competitive in the access services market.

Access charges based on incremental costs would be considerably lower than current access charges. Current interstate access rates recover not only the incremental cost of providing access, but also costs, including non-traffic-sensitive network costs and other common costs, that regulators have allocated to the interstate level through the jurisdictional separations process. The difference between the incremental cost of providing access services, and the rates currently charged by the LECs, is not evidence of LEC inefficiency. Rather, it is the direct result of the historic policy decisions of the FCC and state regulators to recover a significant share of non-traffic-sensitive costs through interstate access rates. Moreover, the LECs are required under the FCC's separations rules to allocate these costs to the interstate jurisdiction, and are prohibited from recovering the amount allocated to the interstate jurisdiction through intrastate rates.

In the *Access Reform NPRM*, the Commission recognizes that the jurisdictional separations process results in "implicit support flows" from the interstate jurisdiction to the intrastate jurisdiction, and that these support flows currently are recovered in the LECs' interstate access rates.[23] The Commission also recognizes that access charge reforms that

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[23] As the Commission noted in the *Access Reform NPRM*, "[i]n adopting the Part 69 rules, the Commission did not seek to eliminate implicit support flows, but in fact incorporated such flows into the Part 69 rate structure. Our Part 69 rules are designed to be consistent with our jurisdictional separations rules that govern the allocation of incumbent
(continued...)

result in access rates based on economic costs will generate access revenues for the LECs that are significantly below their current revenues.

So long as the LECs are required by the Commission's rules to allocate to the interstate jurisdiction costs in excess of the incremental costs of providing interstate services, including non-traffic-sensitive and other common costs currently allocated to the federal level, the LECs must have a means to recover these costs. In enacting the Telecommunications Act of 1996, Congress intended to promote competition, not to adopt a confiscatory law or remove the LECs' legal right to recover the prudently incurred costs that they are required to allocate to the federal jurisdiction.

The current allocation of costs to the interstate jurisdiction is the complex legacy of six decades of political decisions, adopted to further explicit policy objectives. This affidavit traces the origins of the current structure and summarizes the Commission's intimate involvement in the long history of the decisions about which costs would be recovered through interstate access charges. This historical review serves to highlight a simple point: if the Commission shifts to a new regime for setting access charges, such as either alternative proposed in the *Notice*, it must permit the LECs a reasonable opportunity to recover, through some other specific mechanism, the jurisdictionally interstate costs that are no longer recovered in interstate access rates. These costs are real; they have never been disallowed by any regulator in a prudency review. Absent significant policy changes that are not now under consideration or anticipated, the LECs will not be able to recover these costs in the intrastate jurisdiction.

[23/](...continued)
LECs' expenses and investment between the interstate and state jurisdictions." *Access Reform NPRM* at ¶ 6.

If the Commission now shifts to a new basis for calculating access charges that results in significant reductions in such charges, it cannot disclaim responsibility for the resulting gap between the LECs' interstate costs and revenues.[24] The Commission must determine how these costs will be recovered in the future.

The broader purpose of this affidavit is to demonstrate the Commission's obligation -- stemming from the legacy of the separations process, in which it was a major participant -- to address this issue. Several possible recovery mechanisms are discussed in the *Access Reform NPRM*, including permitting LECs to recover any costs found to constitute implicit subsidies through the new universal service regime to be adopted in CC Docket 96-45,[25] or establishing a transition recovery mechanism.

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[24] In the *Notice* the Commission appears, commendably, to recognize that its longstanding, direct involvement in setting the jurisdictional separations rules, which drive current interstate access rates, precludes the Commission from disclaiming responsibility to provide for the recovery of costs it has required the LECs to allocate to the interstate jurisdiction. The Commission does not, and should not, pursue the same line of reasoning with respect to access charges that it followed in adopting a forward-looking, long-run incremental costing standard for pricing network elements in CC Docket No. 96-98. In that proceeding, the Commission disclaimed any responsibility for the fact that this standard would leave the LECs with billions of dollars in unrecoverable network costs, in part, based on the fact that it had never previously regulated the pricing of network elements.

[25] The Federal-State Joint Board on Universal Service did not recommend that costs assigned to the interstate jurisdiction, but not recovered in future access charges, be recovered in universal service support mechanisms. *See Federal-State Joint Board on "Universal Judgment Service*, Recommended Decision, CC Docket No. 96-45 (rel. Nov. 8, 1996). However, the Commission has not yet acted on the Joint Board's recommendations. In the *Access Reform NPRM*, the Commission recognized that "because of the role that access charges have played in funding and maintaining universal service, it is important to implement changes in the access charge system together with complementary charges in the universal service system." *Access Reform NPRM* at ¶ 40.

Regardless of the mechanisms chosen, the Commission has a legal obligation to provide LECs the opportunity to recover these costs if they are removed from existing access prices.

III. The Current Allocation of Costs to the Interstate Jurisdiction Is the Product of a Long History of Regulatory Compromises Designed to Further Specific Public Policy Goals

In theory, the jurisdictional separations process divides the costs of a LEC's network and operations between the federal and state jurisdictions based on cost causation principles. But in practice, such principles cannot be used to allocate the majority of telephone company costs, because they are non-traffic-sensitive. For instance, local loop plant, which is by far the largest category of non-traffic-sensitive costs, accounts for 41 percent of LECs' total unseparated costs. These costs are unrelated to the relative levels of interstate and intrastate usage. There are many possible methods for allocating such costs; the process used by the FCC and state regulators has been based on "informed judgment" -- a process of balancing various interests in order to further non-economic policy goals, including the goal of keeping local telephone service rates low. This has been achieved by sharing the recovery of non-traffic-sensitive costs and other common costs between the interstate and intrastate jurisdictions.

Significant vestiges of these historic practices continue to exist in the jurisdictional separations rules that apply currently to the LECs. For example, under the rules, 25 percent of loop plant costs currently are allocated to the interstate jurisdiction, accounting for more than 40 percent of the LECs' total interstate costs.[26] The LECs currently recover these costs through their interstate access rates. The FCC phased in the 25 percent allocation of local loop costs to the interstate level over a seven year period between 1986 and 1993.[27] As discussed in greater detail below, this 25 percent gross allocator does not reflect the inherent share of loop costs attributable to interstate service. Instead, it represents a compromise among the federal and state regulators to promote their respective policy goals.

Thus, the separations process has provided a regulatory mechanism that allows the introduction of significant contribution flows (revenues exceeding the directly-identified costs for such services) among interstate and intrastate services. This has occurred since the inception of the process. In essence, the current arrangement is a compact among the FCC, state regulators, and the LEC industry, whereby the LECs are given the opportunity to recover through their interstate and intrastate rates the non-traffic-sensitive costs that are necessary to provide regulated telephone services.[28]

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[26] *Amendment of Part 67*, Decision and Order, 96 FCC 2d 781 1984); and LEC separations manuals.

[27] *Amendment of Part 67*, Decision and Order, 96 FCC 2d 781 (1984).

[28] *FCC Task Force* at 63. "The Separations procedures constitute a 'treaty' between the Commission and the state commissions that carefully balances a number of conflicting social objectives and competing interests."

A. **Evolution of the Jurisdictional Separations Process: The Gradual Increase in the Allocation of LEC Costs to the Interstate Jurisdiction**

The origins of the separations process antedate even the Communications Act of 1934, tracing back to the Supreme Court's 1930 decision in *Smith v. Illinois Bell Tel. Co.*[29] There, the Court found that the separation of a telephone company's costs between the interstate and intrastate jurisdictions was "essential to the appropriate recognition of the competent governmental authority in each field of regulation."[30]

Seventeen years later, in 1947, the first Separations Manual was adopted. The 1947 Manual required AT&T to separate costs and capital stock into intrastate and interstate categories, calculate the revenue requirements of the two parts of the separated capital stock, and divide the revenues received between Long Lines and the local telephone companies (both Bell and independent) in accordance with these revenue requirements.[31] Most important, all of the costs of the local exchange plant were divided between the interstate and intrastate jurisdictions on the basis of relative use measured by "subscriber line use" or "SLU."[32]

Over the next several years, regulators used the ambiguities inherent in the broad separations allocators to promote universal local telephone service by artificially maintaining high interstate toll rates, or at a minimum, by ensuring that such rates declined more slowly

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[29] 282 U.S. 133 (1930).

[30] *Id.* at 145.

[31] Separations Manual, October 1947 *cited in* Temin, *The Fall of the Bell System: A Study in Pricing and Politics* (1987) at 24.

[32] SLU is defined as "the time the local plant was used for interstate calls divided by its total time in use." Temin at 23-24, n. 28.

than the decrease in underlying costs.[33] State regulators supported this practice because it kept their constituents' local telephone service rates low. The FCC supported these practices as well, because they allowed the agency to share political credit for advancing universal telephone service. Nor did AT&T resist these policies. Although AT&T's Long Lines operation was required, before divestiture, to charge higher rates for interstate toll service than otherwise, the company was not harmed because (1) rate of return regulation enabled it to recover additional revenues from any such jurisdictionally allocated costs, and (2) it faced no competitive pressure to price interstate services in proportion to their actual costs.

Advances in long distance technology rapidly reduced costs throughout the telecommunications industry, making it relatively easy for federal and state regulators to reach agreement on amendments to the jurisdictional separations process that shifted an ever greater share of LEC costs to the interstate jurisdiction. Rapidly declining costs made it possible to reduce interstate toll rates, even as the share of LEC costs assigned to the interstate level was increasing. Lower rates stimulated demand for interstate toll services, generating additional revenues and allowing further rate reductions. At the same time, the allocation of an ever increasing percentage of LEC costs to the interstate jurisdiction allowed local telephone service rates to remain artificially low.

On several occasions between the late 1940s and the 1970s, significant jurisdictional separations "treaties" were agreed to that resulted in increased allocations of LEC costs to the interstate jurisdiction. Figure 1 traces these revisions to the Separations Manual. These revisions forced AT&T to keep interstate toll rates high enough to recover the increasing

[33] The states generally follow a similar practice in pricing toll calls within their borders.

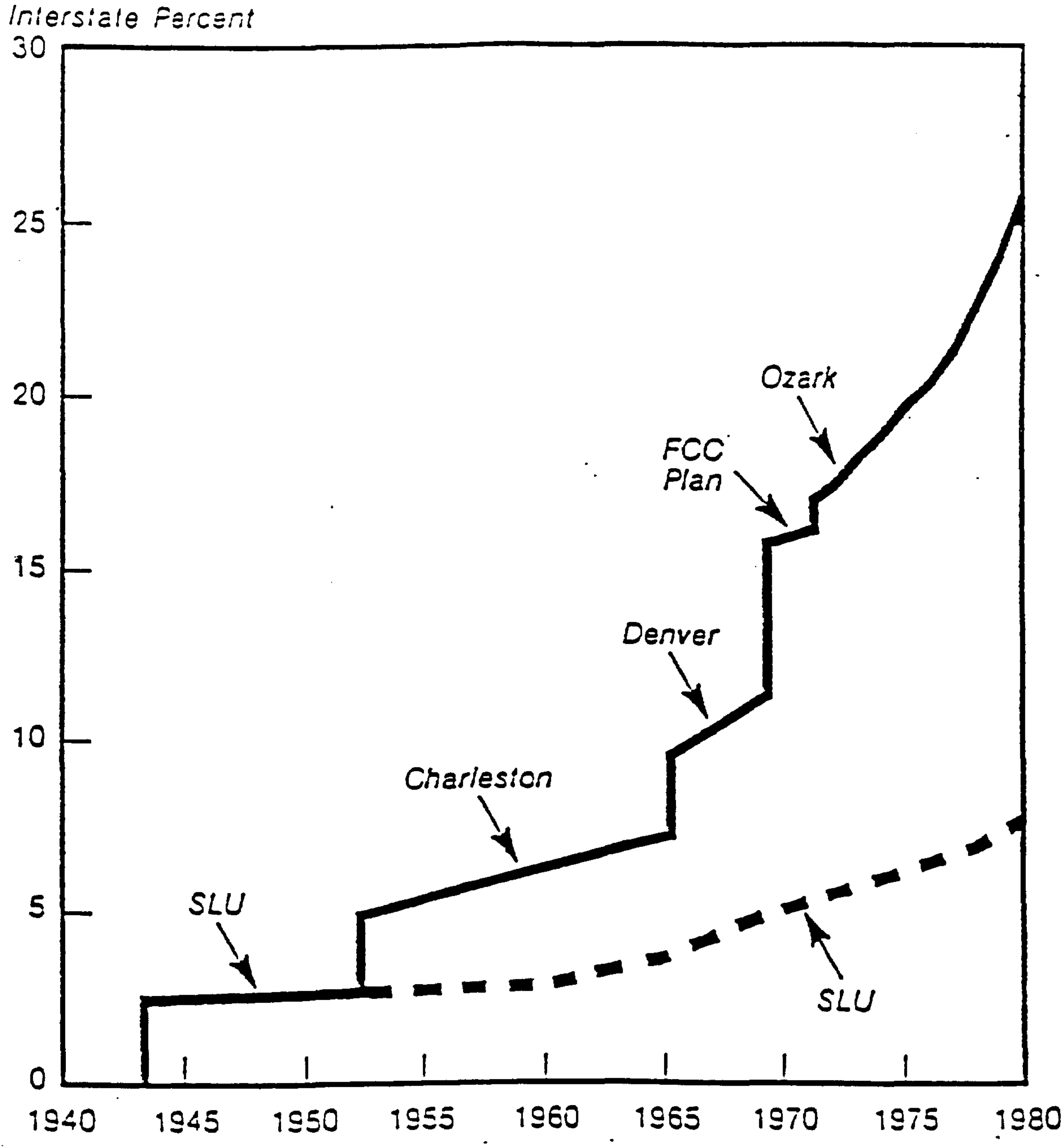

Figure 1.

(Source: P. Temin, The Fall of the Bell System 1987 at 26.)

share of non-traffic-sensitive costs allocated to the interstate level. While toll rates generally declined over this period, they were much higher than they would have been if regulators had not determined to use them to recover these additional costs. (Eventually, such government-mandated pricing created strong artificial economic incentives for competitive entry into interstate service and made such price/cost disparities increasingly untenable for AT&T.)

Perhaps the best example of the use of the separations process to promote universal local telephone service occurred with the FCC's implementation of the Ozark Plan in 1971.[34] This revision of the Separations Manual introduced the concept of the Subscriber Plant Factor ("SPF"). The starting point for computing the SPF was SLU (subscriber line use), the allocation standard established in the 1947 Separations Manual. But the SPF allocated an even higher proportion of local plant costs to the interstate jurisdiction than did SLU.[35] Indeed, under the Ozark Plan, the allocation of non-traffic-sensitive plant costs to the federal jurisdiction was approximately 3.3 times the proportion of interstate calling relative to intrastate calling.[36] The Commission approved the Ozark Plan in full

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[34] *Prescription of Procedures for Separating and Allocating Plant Investment, Operating Expenses, Taxes, and Reserves Between the Intrastate and Interstate Operations of Telephone Companies, Recommended Report and Order*, 26 FCC 2d 248 (1970) ("*Separations Procedures Order*")

[35] The specific formula combines SPF = 0.85 SLU + (2 SLU x CSR) where CSR is the composite station rate (a ratio that combines measurements of average initial three minute station charges and average lengths of haul for interstate toll calls). *See Amendment of Part 67*, Notice of Proposed Rulemaking and Order Establishing a Joint Board, 78 FCC 2d 837, 841 (1980). Both the CSR and the 0.85 exchange cost factor were frozen for the industry at the adoption of the Ozark Plan in 1971. The 0.85 exchange cost factor was constant on an industry basis while the CSR was constant on a state basis.

[36] *See MCI v. FCC*, 750 F.2d 135, 137 (D.C. Cir. 1984).

knowledge of the fact that its implementation at the time would add $130 million to the interstate revenue requirement.[37]

The ostensible justification for attributing a large share of non-traffic-sensitive costs to the interstate jurisdiction rested, in essence, on the fact that local calling typically was a flat-rate service, while interstate toll calling was charged by the minute.[38] It was viewed as unfair by state regulators to allocate non-traffic sensitive costs in simple proportion to actual minutes of local and interstate calling, since per-minute tariffing of interstate toll service was viewed as deterring subscribers from placing interstate calls, while flat-rate tariffing of local calls was viewed as encouraging such calls. The SPF was thought to compensate for the high level of local calling relative to interstate calling attributable to the rate structures for the two types of service. The net effect of the Ozark Plan was to cause AT&T to send about half of the revenues it collected for interstate toll service to its Bell operating company affiliates in the form of "settlement" payments.

For a time, this policy of attributing an ever-increasing share of the local telephone companies' non-traffic-sensitive and other common costs to the interstate jurisdiction was very successful. By imposing on interstate toll callers non-traffic-sensitive costs that reached approximately $7 billion annually,[39] the transfer made a major contribution to the

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[37] *Separations Procedures Order*, dissenting opinion of Commissioner Johnson, 26 FCC 2d at 259-264.

[38] 26 FCC 2d. at 251. *See* also *MCI v. FCC*, 750 F.2d 137 (D.C. Cir. 1984) at 138, n.3, citing *AT&T*, Order, 9 FCC 2d 30 (1967) at 102.

[39] Temin at 357, *citing* Temin & Peters, "Cross-Subsidization in Telephone Network," 21 Willamette Law Review 199-223 (Spring 1985).

55 percent decline in real terms of the price of basic local service between 1940 and 1980.[40] And that, in turn, helped raise the proportion of households subscribing to telephone service from 37 percent in 1940 to more than 93.9 percent by 1996.[41] By 1983, it was estimated that 40 percent of interstate revenues were being used to keep local rates at reasonable levels.[42] As described more thoroughly below, however, the advent of interstate toll competition eventually created marketplace pressures that made these arrangements untenable.

B. Adaptation of the Jurisdictional Separations Process to Competition in Interstate Toll Service

In the years following the adoption of the Ozark Plan in 1971, the telecommunications industry underwent several fundamental changes, including, perhaps most significantly, the authorization of interstate toll competition. In addition, AT&T's divestiture of the BOCs enhanced that competition and created its own ripple effects of change. The confluence of these changes created powerful incentives for AT&T to begin resisting the historic bases for the allocation of costs between the jurisdictions. Perhaps most obviously, the divestiture of the BOCs meant that the funds paid by AT&T for its use of local networks no longer

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[40] Kahn & Shew, "Current Issues in Telecommunications Regulation: Pricing," 4 Yale J. on Reg. 191, 194-95 (1987) at 195, *citing* AT&T Economic Analysis Section, Relative Costs of Telephone Service 1940-1980 (1980).

[41] *Id. Citing* U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the U.S. 495 (90th ed. 1969); and FCC, Telephone Subscribership in the United States (rel. Sept. 18, 1996).

[42] Remarks of C. Brown, AT&T Annual Meeting, Atlanta, Georgia, April 20, 1983, *cited in* Temin at 307.

constituted an internal transfer that remained within the AT&T corporate family.[43] Even prior to divestiture, AT&T objected to the fact that its interstate toll competitors were able to avoid contributing toward the recovery of the local network costs assigned to the interstate jurisdiction.[44] Under the rules in effect at the time, these costs were recovered almost entirely through switched long distance service rates. AT&T's competitors avoided them by providing their services over private lines leased from AT&T. To add insult to AT&T's injury, this situation allowed its competitors to undercut AT&T's interstate toll rates.

Following divestiture, the new Bell operating companies (BOCs) also were adversely affected by the separations process. The process encouraged interexchange carriers and end users to engage in uneconomic bypass of the BOCs' facilities, in order to avoid having to pay the mandated access charges covering a substantial portion of the BOCs' non-traffic-sensitive costs.

To minimize these adverse effects, AT&T began to advocate the need for separations reform to better reflect the economic cost of regulated interstate services. AT&T argued that, principally as a result of the Ozark Plan's SPF factor, MTS/WATS usage was resulting in an assignment of non-traffic-sensitive costs to the interstate jurisdiction at a weighing of a nationwide average of 3.3 times the relative use of LEC networks for interstate services.[45]

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[43] AT&T's "settlement" payments to independent telephone companies gave them no significant incentive to appeal the plan either since these payments constituted less than 20% of all interstate settlement payments.

[44] 78 FCC 2d at 849.

[45] *Id.*

In June 1980, the FCC established a Federal-State Joint Board to examine the separations treatment of non-traffic-sensitive plant. The Commission adopted the Joint Board's recommended proposals with minor modifications in February 1982.[46/] Recognizing that the federal share of local non-traffic-sensitive costs was significantly above the economic costs of the local loop, the FCC froze the total interstate contribution, SPF, at the average 1981 annual percentage levels, as an interim measure pending the development of comprehensive revisions in the separations procedures.[47/] This marked the end of the "three-for-one" Ozark Plan. While the freeze imposed a cap on the percentage of non-traffic-sensitive costs allocated to the interstate jurisdiction, it allowed a growth in the absolute dollar allocation; thus as non-traffic-sensitive costs increased because of inflation or additional investment, the interstate share of those total costs would also increase.[48/]

MCI challenged the SPF freeze in the U.S. Court of Appeals for the D.C. Circuit, arguing that the FCC should have reduced the interstate allocation instead of merely freezing it at a level almost three times above what relative usage would dictate. But MCI lost its appeal. The court ruled that the FCC's rationale for imposing the SPF freeze -- to preserve the Commission's ability to implement comprehensive separations revisions in a manner that would cause the least upheaval in the industry -- was reasonable.[49/] The court went on to

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46/ *Amendment of Part 67*, Decision and Order, 89 FCC 2d 1 (1982).

47/ *Id. See,* also, 47 C.F.R. § 67. 124 (d) (1989)

48/ *Amendment of Part 67*, Decision and Order, 89 FCC 2d, (1982) at 13-14.

49/ 750 F.2d at 141.

acknowledge that "[c]ost allocation is not purely an economic issue, it necessarily involves policy choices that are not constitutionally prescribed."[50]

As part of a comprehensive reform of the separations process, the FCC ultimately reduced the allocation to the interstate jurisdiction caused by the SPF. In 1983, the FCC extended the SPF freeze until 1986, after which SPF was phased out over a seven year period. The transition to a "base factor apportionment," set at an unvarying 25 percent, began in 1987 and was completed in 1993.[51] The decision to set the allocation factor at 25 percent was an economically arbitrary, pure policy -driver decision. Indeed, the Commission never attempted to explain or justify the 25 percent allocation factor in economic terms; rather, the Commission justified it on the basis of its proximity to the then-current percentage of costs allocated to the interstate jurisdiction. This base factor apportionment continues to be used today, resulting in the allocation of 25 percent of non-traffic-sensitive loop costs to the interstate jurisdiction.

In 1978, the FCC established a Joint Board to determine "what reimbursement interstate services should make to local operating companies for the use of local plant" and "whether and how these charges can be equitably imposed on all interstate services."[52] An important first step proposed by the Joint Board was the introduction of limited flat-rated monthly charges assessed to all subscribers ("subscriber line charges" or "SLCs") to recover

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[50] *Id.*

[51] *Jurisdictional Separations Procedures*, Decision and Order, 49 Fed. Reg. 7934 (1984).

[52] *MTS and WATS Market Structure*, Notice of Inquiry and Proposed Rulemaking, 67 FCC 2d 757,759 (1978).

some of the interstate non-traffic-sensitive costs that had been bundled into the per-minute rates for access service.

Implementation of the Joint Board's proposal was among the most controversial actions ever taken by the FCC. From the outset, the Commission recognized two things: that the introduction of the SLC required the cooperation and support of the state commission representatives on the Joint Board; and that given the intensity of the opposition to the SLC, there would be extreme political sensitivity to any further policy changes that could affect local rates. Indeed, decisionmakers often were more concerned with adopting proposals that created the least jurisdictional impact than with implementing the most economically efficient reforms. There was a widespread belief that it was not politically possible to move all, or even most, non-traffic-sensitive LEC costs to the intrastate jurisdiction, and that the transfer of any costs to that jurisdiction should be a gradual process.[53]

Joint Board members realized that if all non-traffic-sensitive costs were allocated to the intrastate jurisdiction, state regulators might consider raising intrastate toll rates in order to minimize the impact on local telephone service rates. Such a development would have harmed competition in the intrastate toll market and would have perpetuated economically inefficient pricing of long distance services, thus harming consumer welfare.

In the end, the Joint Board and the Commission adopted a pragmatic approach; in the interest of ensuring the success of the SLCs initiative, the FCC agreed to tolerate the continued allocation of a significant share of non-traffic-sensitive costs to the interstate

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[53] The deliberate transitional nature of moving intrastate costs to the state jurisdiction was designed to prevent "rate shock" to residential customers of local service. "Rate shock" was typically understood to mean a rapid increase in the price of residential customers' local rates.

jurisdiction even though the FCC believed these costs rationally should have not all be recovered through intrastate level rates. For their part, legislators and state regulators were willing to tolerate the gradual introduction of the SLC on the basis of the FCC's firm committment that the amount of the SLC would be passed through to consumers, dollar for dollar, in the form of interstate toll service rate reductions. In addition, state regulators negotiated agreements to introduce various programs designed to protect the universal service goals (*i.e.*, Lifeline credits and Link-Up America programs).

The decision to allocate 25 percent of all non-traffic-sensitive loop costs to the interstate jurisdiction is the most important example of how the jurisdictional separations rules are used to divide costs between the jurisdictions in furtherance of specific policy objectives.

The following are additional examples of similar separations practices involving the allocation of costs to the interstate jurisdiction. If interstate access rates are driven down to the incremental cost of providing access, the full amount of the costs discussed in these examples will no longer be recovered in such rates. Yet, at least until the separations process is reformed, these costs will continue to be allocated to the interstate jurisdiction. Regardless of the rules the Commission ultimately adopts to govern interstate access service pricing in the future, it must provide a means for the LECs to recover these costs. The Commission cannot -- and as a legal matter may not -- penalize the LECs for its policy decisions reflected in these examples.

C. Current Separations Practices Driven by Policy Considerations

1. Marketing Expenses

Prior to 1987, LEC marketing expenses were allocated between the jurisdictions on the basis of local and toll revenues. In revising the Separations Manual in 1987, the Joint Board recommended, and the FCC adopted, new procedures that allocated marketing expenses on the basis of revenues excluding access revenues.[54]

In their petitions for reconsideration of that order, several LECs argued that a significant shift ($475 million) in revenue requirement to the state jurisdiction would result from the exclusion of access charges in contravention of the Joint Board's goals in that proceeding. On reconsideration, the FCC decided to include access revenues in the allocation factor for marketing expenses as an interim measure pending the outcome of a further inquiry by the Joint Board.[55] The net effect of this change was to allocate about 26 percent of the LECs' total marketing expenses to the interstate jurisdiction.[56] This is a significant allocator, inasmuch as the LECs spend far less on marketing of interstate access service, relative to their interstate revenues, than they spend on marketing their intrastate services. Moreover, as the history of this issue demonstrates, this allocation was chosen precisely because of concerns that the previously approved allocation would have resulted in

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[54] *MTS and WATS Market Structure*, Report and Order, 2 FCC Rcd. 2639 (1987).

[55] *MTS and WATS Market Structure*, Memorandum Opinion and Order on [redacted]